United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLANT

F.R.A.P. 30(c) Proof
of April 4, 1977

76-7607

B
P/

United States Court of Appeals
FOR THE SECOND CIRCUIT

Docket Nos. 76-7607, 76-7619

UNIVERSITY HILL FOUNDATION,
Plaintiff-Appellee and Cross-Appellant,

—against—

GOLDMAN, SACHS & CO.,
Defendant-Appellant and Cross-Appellee.

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK
(71 CIV. 1166 (MEL))

BRIEF FOR APPELLANT, GOLDMAN, SACHS & CO.

SULLIVAN & CROMWELL
48 Wall Street
New York, New York 10005
(212) 952-8100

Attorneys for Appellant,
Goldman, Sachs & Co.

MICHAEL M. MANEY
PHILIP L. GRAHAM, JR.
CHARLES E. DORKEY III
Of Counsel

TABLE OF CONTENTS

Page

Table of Authorities to be Furnished With

Printing

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Docket Nos. 76-7607, 76-7619

-------- * --------

UNIVERSITY HILL FOUNDATION,

Plaintiff-Appellee and Cross-Appellant,

-against-

GOLDMAN, SACHS & CO.,

Defendant-Appellant and Cross-Appellee.

--------- * ---------

BRIEF FOR APPELLANT,
GOLDMAN, SACHS & CO.

Appellant Goldman, Sachs & Co. ("Goldman, Sachs") appeals from a judgment in favor of University Hill Foundation ("University Hill") entered by the District Court for the Southern District of New York (Honorable Morris E. Lasker) after trial to the Court without a jury in this action brought under the federal Securities Acts.* The opinion of the District Court is reported at 422 F. Supp. 879 (S.D. N.Y. 1976).

---

* The statutes and rules involved in this appeal are reproduced as an addendum to this brief.

Preliminary Statement

This case involves the sale by Goldman, Sachs of commercial paper issued by Penn Central Transportation Company ("Penn Central") to the plaintiff's bank in a transaction involving no actual statements. Accordingly, in considering Goldman, Sachs' liability under § 12(2) of the Securities Act of 1933 (15 U.S.C. § 77l(2)), the District Court accepted the plaintiff's contention that Goldman, Sachs' relationship with Penn Central was such as to give rise to a representation, implied by law, by Goldman, Sachs to plaintiff. That representation was that Goldman, Sachs had conducted an investigation into the financial condition of Penn Central of the type normally expected of an underwriter of registered securities, which representation was held to have been false. The holding was made without regard to what plaintiff or its bank understood was represented in view of the relationship between plaintiff and Goldman, Sachs and without regard to any determination that the implied communication was causally related to plaintiff's injury.

Issues Presented For Review

1. With respect to duties imposed by virtue of an implied representation, is not the expectation of the parties

as between the investor-purchaser and the dealer-seller determinative of what representations are to be implied rather than the dealer-seller's relationship with the issuer?

2. In order to find liability under § 12(2), must not there be a determination, supported by record evidence, of a causal connection between the alleged misstatement and injury to the purchaser?

3. Where § 12(2) imposes on the defendant seller the affirmative defense of establishing that it could not reasonably have known of certain facts, must not those facts be established by admissible evidence rather than by hearsay documents?

Statement of the Case

On March 13, 1970, Goldman, Sachs, as dealer, sold two commercial paper notes of Penn Central to Union Bank of Los Angeles ("Union Bank") in the principal amount of $600,000 for a net price of $572,658.33. Although Goldman, Sachs was not aware of the fact at the time, the Penn Central notes were purchased by Union Bank for the account of University Hill. See University Hill Foundation v. Goldman, Sachs & Co., 422 F. Supp. at 885-86. Both notes bore the maturity date of September 25, 1970, slightly more than six months after purchase. The borrower, Penn Central, filed for reorganization

under § 77 of the Bankruptcy Act (11 U.S.C. § 77) on June 21, 1970, and University Hill's notes were not paid at maturity.

On June 29, 1971, University Hill commenced an action against Goldman, Sachs alleging, inter alia, violations of § 12(2) of the 1933 Act, § 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. § 78j(b)) and SEC Rule 10b-5 promulgated thereunder.*

Trial before Judge Lasker began on October 28, 1975, and lasted six days. On October 27, 1976, the District Court filed a decision which held that Goldman, Sachs acted in good faith and without intent to deceive and therefore had not violated § 10(b), but that it had made a single misrepresentation under § 12(2) that rendered it liable to University Hill. On November 10, 1976, judgment was entered in favor of University Hill.

The opinion of the District Court sets forth the facts necessary to understand the commercial paper market, Goldman, Sachs' dealings with Penn Central and University Hill's purchase of commercial paper. 422 F. Supp. at 884-

---

* 17 C.F.R. § 240.10b-5. Plaintiff also alleged claims for relief under various state statutes and the common law. Some of these claims were dismissed for failure to prosecute and the rest were not considered by the District Court in view of its conclusion that University Hill was entitled to rescission under § 12(2). 422 F. Supp. at 883 n.2 & 905.

92.* To the limited extent the District Court's presentation of the facts needs supplementation or correction, such information will be set out in the course of the argument.

The District Court's discussion on liability begins with its finding that in selling the Penn Central commercial paper to Union Bank, Goldman, Sachs made certain implicit statements:

> "We find that Goldman, Sachs impliedly represented that in its opinion, Penn Central was creditworthy. It represented also that there was a reasonable basis for this opinion, i.e., that a reasonable credit investigation had been conducted. . . . We further find that, in the circumstances of this transaction, Goldman, Sachs represented the paper to be rated "Prime" by NCO."

422 F. Supp. at 893.

In analyzing Goldman, Sachs' implicit representation that in its view Penn Central was creditworthy, the court divorced the "honestly held" from the "reasonably held" facet of that representation. The Court treated the issue of the honesty of Goldman, Sachs' judgment first:

---

* Background facts and facts relating to Goldman, Sachs' sale of Penn Central commercial paper to other purchasers can also be found in Franklin Savings Bank v. Levy, Fed. Sec. L. Rep. (CCH) ¶ 95,902 (2d Cir. Mar. 9, 1977), rev'g 406 F. Supp. 40 (S.D.N.Y. 1975); Mallinckrodt Chemical Works v. Goldman, Sachs & Co., 420 F. Supp. 231 (S.D.N.Y. 1976); Alton Box Board Co. v. Goldman, Sachs & Co., 418 F. Supp. 1149 (E.D. Mo. 1976), appeal docketed, No. 76-1697 (8th Cir. Aug. 17, 1976).

"We find that based upon their perception of the Company's difficulties and its plans and capacity to deal with them, the men in charge at Goldman, Sachs did in good faith believe that the Company was creditworthy."

422 F. Supp. at 894. Accord, Alton Box Board Co. v. Goldman, Sachs & Co., 418 F. Supp. 1149, 1157 (E.D. Mo. 1976), appeal docketed, No. 76-1697 (8th Cir. Aug. 17, 1976).* The court also considered whether in the circumstances of the commercial paper market and the relationship between the parties, several discrete items of information were required to be be disclosed in order to make Goldman, Sachs' statements not misleading. The court concluded none of the facts was required to be disclosed. 422 F. Supp. at 895-96 (citing Phillips v. Reynolds & Co., 297 F. Supp. 736, 738 (E.D. Pa. 1969)); Accord, Alton Box, 418 F. Supp. at 1154 (Finding No. 48).**

The District Court next held that for a variety of reasons Goldman, Sachs had not omitted to state a material

---

* The conclusions of other courts are of course not binding on this Court or upon University Hill. Such opinions are cited here only for their analysis of the facts and in support of the contentions that certain conclusions of the trial court here were proper.

** Although the District Court's analysis here did not turn to the rubric of "materiality," it is clear that in its view the record evidence failed to show that "the omitted fact[s] would have assumed actual significance in the deliberations of the reasonable [commercial paper investor]." TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

fact in violation of § 12(2) when it did not tell Union Bank of its conversations with NCO regarding NCO's rating of Penn Central's commercial paper as "Prime." 422 F. Supp. at 896-97. Accord, Alton Box, 418 F. Supp. at 1154, 1156.

Finally, the court did impose liability upon Goldman, Sachs on the ground that it had falsely represented that it had conducted a reasonable credit investigation of Penn Central. In reaching its result, the District Court first articulated the duty which Goldman, Sachs owed University Hill by reference to what the Court perceived was "a body of law in related contexts." 422 F. Supp. at 897.

The first "body of law" identified by the court involved enforcement actions brought by the Securities and Exchange Commission ("SEC") pursuant to the regulatory role given it by Congress. All of these cases arose under § 10(b) and articulated a doctrine known as the "shingle theory."*

The other "body of law" concerned "civil suits by aggrieved investors against underwriters for failure to investigate statements made in registration materials filed pursuant to § 5 of the Securities Act, 15 U.S.C. § 77e." 422 F. Supp. at 898. In this second group the Court included

---

* Levine v. SEC, 436 F.2d 88 (2d Cir. 1971); Hanly v. SEC, 415 F.2d 589, 597 (2d Cir. 1969); Kahn v. SEC, 297 F.2d 112 (2d Cir. 1961).

two decisions which imported § 11's underwriter* duties into general antifraud sections of the 1934 Act. Chris-Craft Industries, Inc. v. Piper Aircraft Corp., 480 F.2d 341 (2d Cir. 1973) (liability), 516 F.2d 172 (1975) (damages), rev'd sub nom. Piper v. Chris-Craft Industries, Inc., 45 U.S.L.W. 4182 (Feb. 23, 1977) (§ 14(e)); Sanders v. John Nuveen & Co., 524 F.2d 1064 (7th Cir. 1975), vacated and remanded, 425 U.S. 929 (1976) (§ 10(b)).

A fair reading** of the District Court's opinion reveals that it not only measured Goldman, Sachs' investigative duties against the stricter § 11 underwriter standard, but at the same time mixed that § 11 standard, which was designed to prevent misstatements of "facts," with the shingle theory to find Goldman, Sachs liable for the "misstatement" of an implied opinion. 422 F. Supp. at 898. The Court in effect accepted University Hill's contention that Goldman, Sachs had represented that it had made a reasonable credit investigation, and then concluded that liability was to be predicated, not on what such an investigation would or could have uncovered, but rather on what

---

* Section 11 of the Securities Act of 1933, 15 U.S.C. § 77k.

** See especially 422 F. Supp. at 899-900, 903 (citing Feit v. Leasco Data Processing Equipment Corp., 332 F. Supp. 544, 581 (E.D.N.Y. 1971); Escott v. BarChris Constr. Corp., 238 F. Supp. 643, 696-97 (S.D.N.Y. 1968)).

should have been done -- by § 11 standards -- in order "to render its representation that it did so investigate true." *Id.* at 904.

With apparent inconsistency, however, the District Court also acknowledged that there must be a causal relationship between any act by Goldman, Sachs and the injury to plaintiff. 422 F. Supp. at 898, 905. Presumably, in an effort to satisfy that requirement, the court held that further investigation would have led Goldman, Sachs to information on the basis of which it should have concluded that Penn Central was approaching bankruptcy. To reach this result the District Court assumed that Goldman, Sachs could have obtained from the railroad internal projections such as Plaintiff's Exhibits PX-101, -102 and - 103, that such information was true, and that it would have demonstrated the dire condition of the railroad.

ARGUMENT

The difference between what Goldman, Sachs actually represented and what University Hill claims was represented is not, as the District Court stated, 422 F. Supp. at 893 n.14, solely one of semantics. Goldman, Sachs conceded that its offer of commercial paper contained the implied representation that it honestly believed Penn Central to be creditworthy, and that

such an opinion was reasonable on the basis of available information. That requirement -- that available information be assembled and evaluated -- is the standard enunciated by this Court in Franklin Savings Bank v. Levy,* and does not demand that a credit investigation be conducted to obtain verification of published data. It is only in the context of § 11, which creates an affirmative defense to an "underwriter" if it "had, after reasonable investigation, reasonable ground to believe and did believe" that statements were true, that liability is imposed without determining that further inquiry would have uncovered any material information. To suggest, as did the District Court, that Goldman, Sachs reasonably should have demanded verification of the accuracy of statements made by management, and that such failure creates liability regardless of what such additional inquiry would have uncovered, is to impose on Goldman, Sachs the standard of care Congress required only in connection with the sale of a registered offering.

Moreover, the trial court engrafted this onerous duty to investigate into the internal affairs of an issuer upon the obligation, derived from the shingle theory, that a dealer have a reasonable basis for its opinion of creditworthiness. The court thus created a hybrid superinvestment

---

* Fed. Sec. L. Rep. (CCH) ¶ 95,902, at 91,357 (2d Cir. Mar. 9, 1977).

adviser with both the duties of an underwriter and of a broker-dealer. The result is to impose upon the commercial paper dealer a duty to justify an opinion implied by law, based upon an extraordinary investigation more burdensome than the one from which he is statutorily exempt.

The United States Supreme Court has recently and repeatedly admonished lower courts and enforcement agencies that the statutory framework enacted by Congress takes precedence over administrative rules or judicial gloss. When Congress determined that the relationship between the parties in the commercial paper market justified exemption of commercial paper from the registration requirements of the Securities Act,* and when Congress imposed particular obligations on participants in registered offerings but carefully prescribed different obligations on participants in other situations, those distinctions should not be ignored or obliterated by wholesale incorporation of such words as "underwriter" or "shingle theory" in totally different factual contexts.

Goldman, Sachs' conduct should be measured in the light of all the circumstances consistent with the specific statutory language of § 12(2). In order to assume

---

* Section 3(a)(3) of the Securities Act of 1933, 15 U.S.C. § 77c(a)(3).

that further investigation was appropriate or necessary, the District Court should have been required to find that a causal connection existed between the failure to investigate further and an injury to plaintiff. To the limited extent that such a finding was made by the District Court at all, it was premised on an erroneous and unsupported assumption: that requests by Goldman, Sachs for verification would have been honored and would have resulted in obtaining certain specific documents, and that those hearsay documents admitted into evidence over strenuous objection, faithfully represented the true financial condition of Penn Central.

The record evidence establishes that, when pressed for detail, the financial officers of Penn Central furnished to others exactly the same information as was given orally to Goldman, Sachs. The record evidence further establishes that documents such as those admitted without adequate foundation would never have been turned over to Penn Central's commercial bankers, investment bankers or commercial paper dealer. The record is totally barren of any evidence to give significance or content to the hearsay projections on which the trial court placed such total reliance.

Measured against the proper standard of care, in light of what Goldman, Sachs actually represented to this plaintiff, the District Court's finding that Goldman, Sachs

did not reasonably believe in the creditworthiness of Penn Central is reversible error.

Had the District Court applied the proper standard and had it not relied on unreliable, hearsay evidence, there is no doubt it would have reached the same conclusion as that of the court in a related case:

> "After careful review of all the evidence, it is the opinion of the Court that defendant, Goldman, Sachs, was warranted in continuing to assert that Penn Central Transportation Company was creditworthy, and in continuing to sell Penn Central commercial paper."

Alton Box Board Co. v. Goldman, Sachs & Co., 418 F. Supp. 1149, 1154 (E.D. Mo. 1976); cf. Mallinckrodt Chemical Works v. Goldman, Sachs & Co., 420 F. Supp. 231, 242-43 (S.D.N.Y. 1976).

I.

THE DISTRICT COURT IMPOSED AN ERRONEOUS STANDARD

The opinion of the District Court was written prior to this Court's decision in Franklin Savings Bank v. Levy, Fed. Sec. L. Rep. (CCH) ¶ 95,902 (2d Cir. Mar. 9, 1977), where this Court announced the standard to be applied on remand for assessing whether Goldman, Sachs had acted reasonably in selling Penn Central commercial paper to another purchaser. In a word, Judge Lasker's opinion is inconsistent with Franklin.

In Franklin, the judgment of the District Court was reversed principally for evidentiary errors and the cause remanded to consider the single issue, under § 12(2), whether

> "it was not reasonable for [Goldman, Sachs] to have determined on March 16, 1970 [the date of Franklin's purchase] that the quality of paper it was purveying was less than that represented."

Id. at 91,357. In reaching its result, this Court explicitly embraced the "shingle theory" as determining liability under § 12(2) for the "misrepresentation" of an opinion:

> "The distinction between liability for the misrepresentation of a fact and the mere expression of an opinion is appreciated if at times difficult to make. We have been loath, however, to permit a broker-dealer to escape liability under § 10(b) of the 1934 Act by recourse to the fact-opinion dichotomy. We have held that where a broker-dealer makes a representation as to the quality of the security he sells, he impliedly represents that he has an adequate basis in fact for the opinion he renders. Hanly v. Securities & Exchange Commission, 415 F.2d 589, 596-97 (2d Cir. 1969). We see no reason why that theory is not at least equally appropriate in cases involving § 12(2) of the 1933 Act."

Id. at 91,356-57 (footnote omitted).

As shown below, the duty articulated in the "shingle theory" cases depends upon the relationship between the seller and buyer of the security in question. The relationship here, however, is not such as to give rise to the duty imposed by the trial court.

A. The Duty To Investigate is Determined By The Relationship Between The Dealer And The Customer

In Franklin, this Court articulated the standard to be applied in testing whether a commercial paper dealer has a reasonable basis for its opinion of the creditworthiness of of an issuer:

> "If Goldman, Sachs failed to exercise reasonable professional care in assembling and evaluating the financial data, particularly in view of the worsening condition of Penn Central, then its representation . . . was untrue in fact and misleading no matter how honestly but mistakenly held."

Id. at 91,357 (emphasis added). The choice of the word "assembling" cannot be presumed inadvertent* and when coupled with the Court's emphasis on the relationship between Goldman, Sachs and Franklin, a pattern emerges -- a pattern consistent with prior cases articulating the "shingle theory."

---

* That Franklin did not imply an underwriter's duty to investigate into § 12(2) is confirmed by a reading of the concurring and dissenting opinion of Judge Van Graafeiland, who agreed that the case was to be remanded but disagreed on the standard to be applied on remand. In discussing the majority's holding he wrote:

> "However, I do not agree that the proper test of defendants' liability under § 12(2) is whether they exercised reasonable professional care in evaluating financial data."

Id. at 91,359 (emphasis added).

The crux of the shingle theory is "the personal rapport between the parties." Jacobs, The Impact of Securities Exchange Act Rule 10b-5 on Broker-Dealers, 57 Corn. L. Rev. 869, 878 (1972). Indeed, the "shingle theory" was first articulated to prevent the abuses inherent in a "boiler room" where a securities broker would apply high pressure sales tactics to sell the stock of a particular company. R. Jennings & H. Marsh, Securities Regulation 821-26 (3d ed. 1972). One oft-used technique was to use unconfirmed and extravagant reports, especially predictions of future earnings, actively to solicit orders for speculative stock. E.g., Hiller v. SEC, 429 F.2d 856, 857 n.1 (2d Cir. 1970). In order to protect the public, the SEC took administrative action against those brokers under the "shingle theory" which "was evolved by the [SEC] as a basis for a finding of statutory fraud . . . in a case where no intentional misstatement or omission on the part of the broker-dealer could be established." R. Jennings & H. Marsh, Securities Regulation 821 (3d ed. 1972).

In Hanly v. SEC, 415 F.2d 589 (2d Cir. 1969), this Court upheld the SEC's use of the shingle theory in a case not involving a boiler room. Id. at 597 n. 14. This Court, however, carefully limited its opinion by noting that it was essentially deferring to agency expertise, id. at 595, that there was no claim for monetary damage, id., and that it was dealing with the over-the-counter market where "[t]hose who

purchased . . . could not readily confirm the information given them." Id. at 597. Most importantly, the Court made clear that the concern of the shingle theory was to insure that the sellers did not "take advantage of customers in whom confidence has been instilled." Id.

Cases following Hanly have emphasized the relationship between the broker-dealer and the customer, e.g., Hiller v. SEC, 429 F.2d 856 (2d Cir. 1970); Canizaro v. Kohlmeyer & Co., 370 F. Supp. 282, 289 (E.D. La. 1974); aff'd per curiam, 512 F.2d 484 (5th Cir. 1975), and the presence vel non of a recommendation or other affirmative behavior by the dealer. E.g., SEC v. Rega, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,222, at 98,148 (S.D.N.Y. 1975); Wohl v. Blair & Co., 50 F.R.D. 89, 91 (S.D.N.Y. 1970) (Mansfield, J.).

B. The Relationship Between Goldman, Sachs and University Hill Shows That Goldman, Sachs Had a Minimal, If Any, Duty to Investigate

The pattern which emerges from the cases set out above is that the critical element in determining the duty owed under the "shingle theory" is the relationship between the dealer and his customer, and especially the existence of selling pressure. The relationship between the dealer and the issuer is important only once there is established the existence of an extraordinary set of circumstances justifying investigation -- as opposed to analysis.

The most striking fact about University Hill's relationship with Goldman, Sachs, however, is the complete absence of one. University Hill never dealt with Goldman, Sachs directly but always purchased commercial paper through an agent -- usually a large commercial bank. (Fitzpatrick, Tr. 105). Moreover, University Hill would not deal exclusively with one bank but would call two or more. (Id. 106-07). Further, University Hill would request each bank to contact two or three commercial paper dealers who would each usually supply the names of three or four commercial paper issuers. (Id. 111-113; LeMay, Tr. 6, 15-16). University Hill thus had from twelve to twenty-four names in front of it before purchasing the commercial paper at issue: its relationship with Goldman, Sachs in this case was fortuitous at best.

This then is not the typical shingle theory case. There was no "boiler room." There was no forceful sales presentation.* There was not even an attempt by Goldman, Sachs to sell the commercial paper of only one issuer. There was no statement made that could in any way be construed as a projection, an estimate of future earnings, or a

---

* See Charles Hughes & Co. v. SEC, 139 F.2d 434, 435-36 (2d Cir. 1943), cert. denied, 321 U.S. 786 (1944).

statement of particular value. Indeed, there was no recommendation.* See 422 F. Supp. at 895.

The absence of any recommendation distinguishes this case from not only the boiler room cases, but from the conclusions of this Court in Franklin. In Franklin, this Court found an implied representation that Goldman, Sachs had conducted an ongoing investigation by virtue of the following "undertaking":

> "[Goldman, Sachs] was a professional vendor admittedly recommending this paper for sale to an institution authorized by statute to invest in prime paper."

Fed. Sec. L. Rep. (CCH) ¶ 95,902, at 91,357. Here, University Hill was not restricted by statute or otherwise to buying only paper rated "Prime." More critically, there was no recommendation by Goldman, Sachs.

University Hill had no expectation that Goldman, Sachs would perform any investigation.** Union Bank, University Hill's

---

* According to Noel LeMay, the officer of Union Bank responsible for University Hill's purchases and the man who spoke with the salesmen at Goldman, Sachs, the act of reflecting several names of commercial paper issuers does not constitute a recommendation. (LeMay, Tr. 59).

** In fact, University Hill placed absolutely no reliance on Goldman, Sachs when it purchased the commercial paper at issue and admitted precisely this in its Post-Trial Brief:

(Footnote continued on next page)

Hill's agent, only had the general expectation that Goldman, Sachs would make a "routine" credit investigation and had no expectation in particular with respect to Penn Central. (LeMay, Tr. 65-67). As Mr. LeMay testified, this investigation would include communication with management of the issuer and the assembling of information on Penn Central in accordance with "accepted practice." (LeMay, Tr. 66-68). There is not a shred of evidence in the record that University Hill or Union Bank expected, desired or needed Goldman, Sachs to perform a § 11 underwriter's investigation of Penn Central.

Moreover, there was no expectation in the commercial paper marketplace that Goldman, Sachs would conduct an investigation of the sort envisioned by Judge Lasker. Because "[t]his was neither a market nor an investment vehicle in which widows and orphans sought refuge," Franklin, Fed. Sec. L. Rep. (CCH) ¶ 95,902, at 91,353, the sophisticated participants in the commercial paper market -- unlike the customers

---

(Footnote cont'd)

> "Fitzpatrick then elected to purchase Penn Central commercial paper because:
>
> > 'Principally is the image quality of the size of Penn Central and that meant safety to me, the rate was favorable, and their maturity situation fitted our requirement.'"

Plaintiff's Post-Trial Brief at 24-25 (quoting Fitzpatrick, Tr. 115).

in Harly and other shingle theory cases -- had access to a significant amount of information about commercial paper issuers. Compare Hanly, 415 F.2d at 597. The sophistication of purchasers, then, affected the perception of what credit investigation was to be undertaken by Goldman, Sachs; these purchasers or the agents who acted for them, (Alton Box, 418 F. Supp. at 1156-57), could readily have confirmed the credit-worthiness of Penn Central had they so chosen.

Finally, not only does the evidence show that the relationship between Goldman, Sachs and University Hill called for no extraordinary investigation, but University Hill itself offered no evidence that a reasonable credit analysis consisted of anything more than the actions taken by Goldman, Sachs.* Other than the evidence submitted by Goldman, Sachs demonstrating the reasonableness of its credit judgment,**

---

* University Hill offered no testimony as to the ordinary practice of commercial paper dealers or credit analysts, although such testimony is relevant and admissible.

> "Testimony concerning the ordinary practices of those engaged in the securities business is admissible under the same theory as testimony concerning the ordinary practices of physicians or concerning other trade customs: to enable the jury to evaluate the conduct of the parties against the ordinary practice in the industry. See VI Wigmore on Evidence § 1949, at 66 (3d ed. 1940)."

Marx & Co. v. Diners' Club, Inc., No. 76-7050, at 2020-21 (2d Cir. Feb. 25, 1977).

** See Part II infra. (See also Sullivan, FSB, Tr. 853-54).

"the record is noticeably barren of evidence of practice in the industry and the appropriate standard to be applied under the circumstances." Manheim v. Wood, Walker & Co., Fed. Sec. L. Rep. (CCH) ¶ 95,848, at 91,089 (D. Conn. 1976) (Lumbard, J.). Accord, SEC v. Geon Industries, Inc., 531 F.2d 39, 52-53 (2d Cir. 1976) (Friendly, J.).

C. Because There Was No Representation By Goldman, Sachs That It Had Conducted The Investigation Expected Of An Underwriter There Is No Justification For Imposing Liability By Measuring Goldman, Sachs Against An Underwriter Standard

On the very same page of the reported opinion that lists certain "facts" Goldman, Sachs should supposedly have uncovered, the District Court concedes that "it is uncertain precisely what information a reasonable investigation would have revealed." 422 F. Supp. at 904 n.23. In an apparent shift of opinion the court then makes the shocking statement that what is important "is not what Goldman, Sachs would have learned but what it should have done to discharge its duty reasonably to inquire and to render its representation that it did so investigate true." Id. at 904. In other words, the court assumed the existence of a representation that a credit investigation had been conducted (unsupported by any factual statement and necessarily implied by law) and then used that "representation" as a basis for applying an "underwriter" standard of investigation to hold Goldman,

Sachs liable under a statutory section which does not even deal with underwriters. Moreover, under § 11, an underwriter's duty is at least linked to liability for specific misstatements or omissions. Here the duty is simply to investigate -- apparently regardless of the existence of a factual misstatement or an indication that investigation would make a difference. Nothing in the statutory scheme suggests that liability should be thus imposed.

The statutory scheme imposing civil liability under the 1933 Act reflects certain carefully circumscribed obligations, including those imposed upon underwriters as defined in the statute. As the Supreme Court has recognized, the 1933 Act is concerned primarily with the initial offering of securities to the public, Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 752 (1975), and provides civil liabilities in three separate provisions:

-- Whether securities are exempt from registration or were registered, the seller may be liable under § 12(2), but there is in that section no reference whatsoever to an "underwriter" and thus no duties are imposed even if a dealer fits within the definition of underwriter contained in the statute;

-- If securities are not exempt from registration and were not registered, the seller is absolutely liable under § 12(1);*

-- If securities are required to be registered and are registered, the obligations of those participating in the offering, including an underwriter, and specific defenses available to them, are set forth in § 11.**

In § 11 of the 1933 Act, Congress expressly and carefully specified the parties responsible for prospectuses and the scope of their respective liabilities. A year later, § 11 was amended so as further to confine the degree of an underwriter's potential liability because Congress concluded that the original provisions, though limited, were not limited enough. Congress considered this amendment the "most important" of the 1934 amendments to the 1933 Act, see Blue Chip Stamps v. Manor Drug Stores, 421 U.S. at 741, 753, and § 11's limitations have been strictly enforced by this court. See Barnes v. Osofsky, 373 F.2d 269 (2d Cir. 1967).

---

* Penn Central was also exempt from § 5 by virtue of its exemption as a transportation company under § 3(a)(6).

** Theoretically they would also be subject to suit under § 12(2), but the burden on a plaintiff is less under § 11.

In this case it is necessary to re-emphasize that Congress concluded that registration under § 5 and the protections afforded investors, including the civil remedies under § 11, were unnecessary in the sale of commercial paper. There is no factual or legal representation in the record of this case, or in the statutory language of § 12(2), from which one could conclude that a § 11 underwriter's investigation should have been undertaken or was represented to have been undertaken.

If there is one lesson which has been stated and restated by the Supreme Court, most recently in Santa Fe Industries, Inc. v. Green, 45 U.S.L.W. 4317 (Mar. 23, 1977) and in Piper v. Chris-Craft Industries, Inc., 45 U.S.L.W. 4182 (Feb. 23, 1977), it is that differing statutory provisions are to be interpreted in accordance with the language employed by Congress; the Courts and the SEC are not to engraft their own gloss from the common law or from one statute onto another.

It is no more appropriate to read "underwriter" into § 12(2) than it is to read deception and fraud out of Rule 10b-5!

It is no more appropriate to create a representation by operation of law that Goldman, Sachs held itself out as an underwriter, when plaintiff admitted that it had no such understanding, than it is to impose damage liability, after

half a decade of discovery, solely upon the Court's assumption that some further investigation should have been conducted, although what it would have revealed is totally unclear.*

The representation actually made by Goldman Sachs was that it believed Penn Central to be creditworthy. That representation, in the circumstances of the relationship between the parties, did not imply or create an obligation to verify representations of management. As discussed hereafter, it is also clear that further inquiry would have revealed no different information than that already represented to Goldman, Sachs.

II.

MEASURED BY THE PROPER STANDARD, THE CONCLUSION THAT GOLDMAN, SACHS VIOLATED ANY DUTY OF CARE OR INVESTIGATION IS CLEARLY ERRONEOUS.

The standard of care set forth in Franklin and examined in Section I of this brief concededly required, in the circumstances of this case, that Goldman, Sachs perform

* On remand from the Supreme Court in the case in which Judge Lasker found most apposite, Sanders v. John Nuveen & Co., it is noteworthy that the SEC has filed an amicus brief in which it acknowledges that the much more limited activity undertaken by the dealer in that case was adequate to meet the standards of § 12(2). The SEC argues that on the particular facts of that case, the notes being sold should not have qualified for exemption from registration under § 5 and, accordingly, that Nuveen should be held absolutely liable under § 12(1).

some analysis of the financial condition of Penn Central. It is submitted, however, that measured against that standard, on the record facts and the findings of the court below, the actions of Goldman, Sachs were entirely appropriate. It was only the trial court's imposition of an erroneous standard that permitted it to find Goldman, Sachs liable to University Hill.

The court specifically found that the kind of investigation and analysis conducted by Goldman, Sachs was generally sufficient for a commercial paper dealer:

> "With full allowance for Goldman, Sachs' obligations under the circumstances, however, we cannot agree with the Foundation that the entire credit investigation was unreasonable because it was based simply upon publicly available information and unverified representations of management. . . . It would be unreasonable to require a commercial paper dealer to conduct far-reaching, firsthand verification of all issuing companies, no matter how strong the indications of financial well-being. . . . Goldman, Sachs' credit file on Penn Central contains a substantial collection of relevant data with which Vogel was at least generally familiar, and his sense of the margin by which the value of assets available to raise cash exceeded the amount of outstanding commercial paper, the so-called credit cushion, appears to have been generally accurate."

422 F. Supp. at 901. The court below thus concluded that the kind of analysis which was in fact performed by Goldman, Sachs would ordinarily be sufficient and the conclusions reached by Goldman, Sachs would ordinarily have been considered reasonable under the circumstances.

With this conclusion, of course, appellant takes no issue. The court went on, however, to conclude that in the circumstances here, Goldman, Sachs should have done more:

> "The question . . . is . . . whether by March 13, 1970, the date of the Foundation's purchase, there were sufficient storm warnings as to the company's insecure condition to render Goldman, Sachs' normal procedures inadequate and to require more concrete verification of management representations and projections. We conclude that such cause existed at least upon the disclosure of the 1969 fourth quarter and year-end figures in early February, 1970."

Id. at 902. The court thus concluded that the confluence of events in early February 1970 created a situation where Goldman, Sachs was put on notice that additional investigation was required. It further found that such additional investigation, if performed, would have uncovered significant additional facts. It will be shown, however, that measured against the representations which may properly be implied as to the nature of Goldman, Sachs' investigation, the events of February 1970 were not sufficient "storm warnings" to require Goldman, Sachs to do anything more than what it actually did. In fact, the uncontradicted evidence shows that the events said to have required Goldman, Sachs to act further were not even material. Moreover, the record is barren of competent evidence, properly admitted, that would give any indication of what Goldman, Sachs might have uncovered had it made some additional investigation.

Perhaps recognizing the weakness of its hypothesis that additional information about Penn Central could have been obtained, the court seems finally to have held that Goldman, Sachs was liable not for its failure to uncover the facts identified, but for its failure to try:

> "The main point, however, is not what Goldman, Sachs would have learned but what it should have done to discharge its duty reasonably to inquire and to render its representation that it did so investigate true."

Id. at 904. In other words, the court said that Goldman, Sachs should have done more -- regardless of whether doing more would have done any good. This rather startling conclusion is at odds with the essential notion that a plaintiff cannot recover except for damage caused it by defendant. If Goldman, Sachs' further inquiries would not have uncovered additional information, then Goldman, Sachs' failure to inquire did not cause plaintiff's injury and ought not to be the basis for recovery. The United States Supreme Court has recently confirmed what this Court concluded in Jackson v. Oppenheim, 533 F.2d 826, 829-30 (2d Cir. 1976), namely that causation is essential to a plaintiff's recovery. See Santa Fe Industries, Inc. v. Green, 45 U.S.L.W. 4317, 4320 n.14 (Mar. 23, 1977).

The fallacy of the trial court's conclusion that recovery can be had regardless of causal nexus underscores the error of relying upon SEC enforcement action precedents

such as Hanly in determining liability to private plaintiffs. It may well be that in an injunction action brought by the SEC, a failure to investigate should be a sufficient basis for relief because of the prospective protection thus afforded to investors. But to say that an individual plaintiff can recover damages for such a generalized breach of duty without evidence that fulfillment of the duty would have altered events, is to permit recovery without establishing causation.

To the extent that the trial court has not relied upon erroneously admitted evidence and clearly erroneous conclusions as to what Goldman, Sachs could have uncovered, it relied upon a fallacious argument -- that faulty investigation, without more, can be a basis for recovery.

A. After Learning of Penn Central's Year End Results, Goldman, Sachs Acted Reasonably In The Circumstances and Performed A Reasonable Credit Analysis

The central event in the trial court's analysis of the facts was the public announcement by Penn Central of its fourth-quarter and year-end results for 1969 on February 5, 1970. It is therefore important to examine Goldman, Sachs' response to that announcement both to show the reasonableness of its actions when measured by the proper standard and as a basis for examining the evidentiary and other errors discussed hereafter.

On February 6, 1970, David Bevan, Chairman of the Finance Committee of Penn Central, and Jonathan O'Herron, financial vice president, met with Gustave L. Levy and Robert G. Wilson to discuss the financial prospects and financing plans of Penn Central.* This meeting began with the discussion of the $56 million operating loss of the transportation company which Bevan "did a thorough job of explaining." (Ex. PX-12). Although this loss was substantial, Wilson did not consider it troublesome when viewed in light of Penn Central's consolidated earnings, its strong asset structure, and management's plans for 1970. (E.g., Wilson, Tr. 892-93).

Included in Bevan's explanation of the 1969 year-end results was the management's projections for 1970. Bevan predicted that the railroad's losses would be $56 million and that the holding company would produce a $20-25 million profit in 1970. Both pieces of information had a positive influence on Wilson's assessment of Penn Central's creditworthiness. The $56 million predicted yearly loss for 1970 was actually favorable news because of Penn Central's history of declining earnings. At last, the railroad's yearly losses had reached bottom.

---

* The following discussion shows that Goldman, Sachs' conduct satisfied the trial court's erroneous "underwriter" standard as well as the less strict standard of investigation required under the "shingle theory" imposed by Franklin.

The trend of railroad earnings had for several years steadily worsened, as anticipated in the financial community, while the two railroads were being merged to realize economies. What Bevan stated on February 6, 1976, was that operating railroad losses in 1970 were not going to get any worse, but that they were going to be the same in 1970 as in 1969. (Wilson, Tr. 891-92, 993-94; Levy, Tr. 760-61). Furthermore, the holding company was able to earn only $4 million in 1969, but in February, 1970, its chief financial officer was predicting that consolidated earnings for 1970 would be five to six times as great.*

The trial court faulted Goldman, Sachs for its "uncritical acceptance of Bevan's forecasts and projections," 422 F. Supp. at 903, as being inconsistent with the duty imposed. Goldman, Sachs' reaction, however, was hardly one of "uncritical acceptance." Jack Vogel, the head of the credit department of the commercial paper department, immediately after receiving the memorandum describing the February 6 meeting (Ex. PX-12), returned to his continuing analysis of the creditworthiness of Penn Central -- an analysis which was unchallenged at trial and which the

---

* As discussed in more detail hereafter, these figures would have been confirmed if Goldman, Sachs had sought documentation of Bevan's statement. (See Ex. AA).

court characterized as "generally accurate." (Vogel, Tr. 543-45). 422 F. Supp. at 901.

Vogel's uncontradicted testimony demonstrates that his asset analysis methodology was appropriate because earnings are substantially less important to a commercial paper credit analysis than other factors which relate to the asset structure and available sources of cash of the company in question, and that there are substantial distinctions between credit analysis and equity analysis. See Mallinckrodt Chemical Works v. Goldman, Sachs & Co., 420 F. Supp. 231, 242 (S.D.N.Y. 1976).

Of course, in the long run substantial losses may erode a balance sheet to the point where the credit of the company comes into doubt. Similarly, losses without any prospect of improvement over time indicate a credit problem in the future. Here, however, the assets were so enormous that the erosion from quarterly losses was comparatively small, and it was universally and reasonably believed on the basis of substantial information that the long-term prospects of the company remained excellent. (Levy, 760-61; Wilson, Tr. 854-56).

The result of Vogel's study, conducted in the days and weeks after the February 6 meeting, was that Penn Central had readily indentifiable more than $600 million in assets

in excess of all debt* on those assets. Vogel reasonably concluded that $600 million of assets which could be pledged, sold, or hypothecated in order to raise cash to meet commercial obligations coming due was an adequate cushion so that Goldman, Sachs could continue to sell Penn Central's commercial paper.

B. The Reaction of the Financial Community and of Plaintiff Itself Shows That the Events In Question Were Not "Storm Warnings" Requiring Action by Goldman, Sachs

As shown above, far from ignoring the developments identified by the court as "storm warnings," Goldman, Sachs responded adequately by its interviews of top financial management, its continued analysis based upon the facts provided by management and its ongoing monitoring of the Penn Central situation. That Goldman, Sachs took these developments sufficiently seriously is also demonstrated by the reactions of other knowledgeable persons at the time.

University Hill's purchase was made on March 13, 1970, about five weeks after the announcement of Penn Central's 1969 losses were carried in the press. Both Fitzpatrick and

---

* In his credit analysis Vogel was quite careful "if there were any encumbrances or any pledges, or whatever [to] deduct from those values whatever the encumbrances or pledges or whatever was." (Vogel, Tr. 505; see also id. 495-96, 550, 552). See Mallinckrodt, 420 F. Supp. at 242.

LeMay regularly read The Wall Street Journal and so had knowledge of those results. (Fitzpatrick, Tr. 101, 123-24; LeMay, Tr. 71-81). E.g., Johnson v. Wiggs, 443 F.2d 803, 806 (5th Cir. 1971). Notwithstanding the broad dissemination of Penn Central's 1969 results, scores of investors, not only University Hill, purchased Penn Central commercial paper after the results had become general knowledge (Ex. CU) and many commercial banks extended loans to the railroad even in the face of this unfavorable news. 422 F. Supp. at 892. Because "[a] major factor in determining whether events are material is the importance attached to them by those who knew about them,"* the reaction of these sophisticated investors and lenders show that the year-end results were not material, let alone "storm warnings." (Vogel, Tr. 547-48; Ex. BY).

The reasonableness of Goldman, Sachs' judgment that Penn Central was creditworthy is also supported by specific testimony that many others at the same time and in similar circumstances held the same opinion. Manufacturers Hanover Trust Co. (Sullivan, FSB Tr. 855, 868-69, 871-72) and First National Bank of Chicago (Corrigan Dep. 5-7, 12-14, 23) agreed that Penn Central was creditworthy and both lent

---

* SEC v. Shapiro, 349 F. Supp. 46, 54 (S.D.N.Y. 1972). Accord, Mittendorf v. J.R. Williston & Beame, Inc., 372 F. Supp. 821, 828 (S.D.N.Y. 1974).

substantial sums of money to Penn Central on that basis in the winter and spring of 1970. (Ex. BY). In addition, the National Credit Office, a division of Dun & Bradstreet ("NCO"), the agency which had assumed by contract the responsibility of rating Penn Central's paper, believed at all relevant times that Penn Central was creditworthy.* (See LeMay, Tr. 39; Vogel, Tr. 533).

The District Court also was impressed by Penn Central's "fundamental dependence on sale of commercial paper," 422 F. Supp. at 903, and thought this to be a warning signal for Goldman, Sachs. But the amount of commercial paper outstanding at any one time was not significant compared to Penn Central's assets. (Vogel, Tr. 493-94; Wilson, Tr. 856-57, 859-60). Commercial paper outstandings grew from $100 million initially to $150 million in the spring of 1969 and then to $200 million. During this time period, not only were the available assets within Penn Central substantially in excess of the outstandings, but even accounts receivable alone were greater than the amount of commercial paper outstanding. (Wilson, Tr. 850-51; Ex. A-21, at 27). And the undisputed fact that $100 million of Penn Central's commercial paper was convertible into bank lines of credit mitigated

---

* In Mallinckrodt, the court found that NCO had acted reasonably in reaching and adhering to its judgment that Penn Central was creditworthy until long after the date of University Hill's purchase. 420 F. Supp. at 242-43.

substantially any supposed "fundamental dependence." Moreover, there was full disclosure of the amount of commercial paper outstanding* and there is no evidence that any person declined to invest in Penn Central because of the level of its outstandings.

III

EVEN IF THE EVENTS CONFRONTING GOLDMAN, SACHS CONSTITUTED "STORM WARNINGS" REQUIRING FURTHER ACTION, THERE IS NO EVIDENCE THAT FURTHER INVESTIGATION WOULD HAVE BEEN FRUITFUL

Having identified certain developments in the financial history of Penn Central that supposedly put Goldman, Sachs on notice that further inquiry was required, the court attempted to identify what it was that Goldman, Sachs would have learned by such further investigation. Most significant among these "facts" is the conclusion of the court that,

> "Had the defendant requested copies of the Company's projected first quarter earnings as they were revised on a bi-weekly basis it would have seen from mid-February through early March the enormity of the 1st quarter results was foreseen." (Plaintiff's Exhibit 101-03)

422 F. Supp at 904.

---

* See In re Penn Central Transportation Co. Notes, 336 I.C.C. 1 (1969) (Ex. PX-64).

The trial court also concluded that Goldman, Sachs had "easy access" to the opinions of other members of the financial community and therefore could have asked Brown Brothers, Harriman why Penn Central's name was removed from their approved list and might also have learned that First National City Bank had "declined to participate in [a loan to Pennco] because of reservations about the continued heavy use of the relatively profitable subsidiary to channel money to the ailing railroad." Id. at 904. As shown below, the assumption that internal projections would have been given to Goldman, Sachs is refuted by the record; the purported projected earnings were erroneously admitted in evidence, were rank hearsay and constitute substantial prejudicial error. In addition, it will be shown that the non-consultation with Brown Brothers Harriman is irrelevant and that the Court's conclusion with respect to First National City Bank is utterly unsupported by the cited testimony and is clearly erroneous.

A. The Decision of the District Court That The Three Documents Could Have Been Obtained From Penn Central Is Unsupported By Any Evidence

According to the District Court, facts learned by Wilson at the meeting of February 6, should have prompted Goldman, Sachs to ask more questions of Penn Central and to obtain documentation of what Penn Central officials were

saying. If this documentation had been obtained, then, according to the court, Goldman, Sachs should have changed its view of Penn Central's creditworthiness.

The court's central conclusion, then, is explicitly premised upon the assumed availability to Goldman, Sachs of Exhibits PX-101, PX-102, PX-103.* That presumption, however, is unsupported by any evidence. Indeed, to the extent there is any evidence in point, it shows that Goldman, Sachs need not and could not have obtained the documents in question.

Before reaching a judgment that an issuer is creditworthy, a dealer in commercial paper is not required to ferret out every conceivable document relating to an issuer's financial condition. The purpose of a credit investigation is not to gather paper to place in files, but to ascertain relevant information on which to predicate a judgment of creditworthiness. If that data can be gleaned from face-to-face encounters with those entrusted with the operation of the issuer, then a reasonable investigation has been conducted. DeMarco v. Edens, 390 F.2d 836, 843 (2d Cir. 1968).

---

* PX-101 (Memorandum of Feb. 6, 1970 from A. M. Underhill to Mr. Saunders); PX-102 (Memorandum of Feb. 19, 1970 from A. M. Underhill to Mr. Saunders) and PX-103 (Memorandum of Mar. 9, 1970 from A. M. Underhill to Mr. Saunders).

What the securities laws do require is that dealer assemble and evaluate pertinent financial data and reach a judgment having a reasonable basis. Franklin, Fed. Sec. L. Rep. (CCH) ¶ 95,902, at 91,357. That is what Goldman, Sachs did.

The reasonableness of Goldman, Sachs' conduct in obtaining information orally but not asking for written support, particularly with respect to the February 6 meeting, is corroborated by the results of a February 5, 1970 meeting between Penn Central and its major New York banks. A memorandum (Ex. AD) prepared by a financial officer of Manufacturers Hanover Trust Company reveals that the banks which met with the Penn Central officials on February 5, 1970, asked the same questions and received the same answers as did Goldman, Sachs during its February 6 meeting.

It is true that these banks received a document which Goldman, Sachs did not. But the existence of that document, entitled "Sources and Applications of Funds," (Ex. AA) merely confirms the propriety of Goldman, Sachs' conduct. Not only did the document not alter the banks' assessment of Penn Central's creditworthiness (Sullivan, FSB Tr. 865-66), but the information it contained was precisely what the Penn Central officials orally told Goldman, Sachs and the banks. The planned loss in 1970 for railroad operations, as shown in

Exhibit AA, was $56 million -- exactly the figure Bevan used at the February 6 meeting. Moreover, the material contained in Exhibit AA is less comprehensive than Bevan's oral report to Goldman, Sachs. Thus the very document which Goldman, Sachs would in all likelihood have seen if Penn Central had shown it any papers whatever would have corroborated all that Goldman, Sachs learned in its meetings.

Equally important, the testimony is uncontradicted that it is not reasonable for financial institutions to ask borrowers to substantiate their predictions in writing (Sullivan, FSB Tr. 866-67; Levy, Tr. 793-96) and the three documents in question are not of the sort that banks or commercial paper dealers receive from issuers. (Wilson, Tr. 1024-26). In the view of John J. Sullivan, the top-level financial officer of Manufacturers Hanover, "It is very unusual" for banks to receive this sort of document. (Sullivan, FSB Tr. 908). The only situation in which Sullivan could state that such documents would be received by a bank were those involving a workout situation. (Id.). According to Sullivan, "a workout situation is a company that is unable to meet maturities as they occur which, of necessity, must then work very closely with its banks to pay off that debt without recourse to a bankruptcy court." (Id. 909). There is no evidence that this was the situation at Penn Central in early February -- or in mid-March -- 1970.

Apart from Exhibit AA there is no instance of any internal financial document being shown to anyone outside of management.

Indeed, the evidence is overwhelming to the contrary. According to the testimony of David Bevan,

> "Q Did Goldman, Sachs ever ask to see your budget?
>
> "A I have no recollection of their asking me, but I would have -- I would have -- before I did anything, I would have asked this legal department, and I am quite sure they would say it was inside information. Companies don't publish their budgets, and I couldn't give you one without giving one to everybody. I am sure that would be improper. I never saw a company yet that published its budget to its stockholders. And if you give it to one person, then you are in trouble if you don't give it to others.
>
> "Q Did you ever publish a synopsis of your budget or short-form budget?
>
> "A No, and I don't think I have ever seen this done by any other company.

(Bevan Dep. 213-14).

The statement of the court that "[t]here is no reason to doubt that the Company would have provided this kind of information to Goldman, Sachs," 422 F. Supp. at 904, is thus wholly unsupported and clearly erroneous. Fed. R. Civ. P. 52(c). The court's statement reflects its assumption that the burden of proof on this issue was on Goldman, Sachs. That

assumption must have been derived from the language of § 12(2) which permits, as an affirmative defense, that the seller "did not know, and in the exercise of reasonable care could not have known," of a particular fact rendering his statement untrue. But as set forth below, there was no "fact" established by evidence sufficient to meet the plaintiff's initial burden of proof so as to bring into play the affirmative defense. In other words, the burden of proof should not shift to Goldman, Sachs to establish that it could not have obtained certain documents unless the materiality -- through admissible evidence -- of the documents is first established. That University Hill failed to do.

B. Exhibits PX-101, PX-102 and PX-103
Were Erroneously Admitted in Evidence

In Marx & Co. v. Diners' Club, Inc., No. 76-7050 (2d Cir. Feb. 25, 1977), this Court confirmed that the recently-enacted Federal Rules of Evidence, although liberally favoring admissibility, do have limits, and limits which if transgressed require reversal.

The trial court here admitted into evidence (Tr. 222), over objection (id. 203-06), PX-102, -102 and -103, internal memoranda extracted by subpoena from the files of Penn Central during the course of litigation (Asay, FSB Tr. 56, 78-79), which set forth the opinions of an unidentified

functionary at Penn Central. These documents were not explained at trial by a witness with knowledge, and indeed were not even adequately authenticated. Fed. R. Evid. 901(a). The court's significant reliance upon them thus requires reversal.

1. The Documents Were Not Authenticated*

The documents in question are not signed and have no indication of authorship. They appear, however, under a cover sheet signed by one A. M. Underhill.

Although Mr. Asay, the "[o]ffice manager in the Legal Department" at Penn Central (Asay, FSB Tr. 56), who was called to authenticate these documents knew "there was an employee by the name of A. M. Underhill," he did not even know the dates that Underhill was with the company. (Id. Tr. 77). As for Mr. Underhill's signature, the best this witness could say was:

> "I am not certain of Mr. Underhill's signature, but I have seen it, and these would appear to be his signature."

(Id. 79) (emphasis added). On cross-examination, this testimony was further weakened:

> "Q. [Mr. Piel] Mr. Asay, did Mr. Underhill ever sign a communication to you?
>
> "A. No sir.

---

* Although at trial Goldman, Sachs did not press its authentication objection "as such" (Tr. 204), it is submitted that the admission of these documents is plain error.

"Q. When you say it is familiar, you mean that when you looked in the file that was sent to you, you saw what we are looking at here, is that right?

"A. Yes, and other documents where he signed, his signature appears."

(Id. 82-83). Because Mr. Asay's sole connection with the signature of Mr. Underhill thus resulted from his role as custodian of post-litigation documents (id. 55-56), the requirement of Rule 901(b)(2) that a "non-expert opinion as to the genuineness of handwriting [be] based upon familiarity not acquired for purposes of the litigation," has not been met.

2. The Documents Are Not Business Records

The only possible exception to the hearsay rules which might justify admission of these documents in evidence would be the Business Records Rule. Fed. R. Evid. 803(6). That rule requires, among other things, that before a document can be admitted the party offering show that

> "it was the regular practice of that business activity to make the memorandum . . . ."

Here, University Hill did not establish this element of Rule 803(b). Only two witnesses were shown this document -- Mr. Asay and Mr. Bevan.* Counsel asked Mr. Asay the following:

---

* Both witnesses testified by deposition. By stipulation Mr. Asay's testimony in the Franklin case was admitted. Mr. Bevan's deposition, as designated, was also introduced into evidence.

> Q. [Counsel to Franklin] I notice each of these memos refers to a meeting on Monday addressed to Mr. Saunders. Are you familiar with any routine of meetings for Monday in which he would be involved?"
>
> A. [Mr. Asay] No."

(Asay, FSB Tr. 81). Although this witness did say, "there appear to be documents of this nature in the file," he added, "I _haven't_ _examined_ _them_ from a study standpoint." (_Id_. 82) (emphasis added).

Mr. Bevan's testimony is more explicit. When confronted with these documents, he responded: "That is not a regular document." (Bevan Dep. 171; _see_ _id_. 170-72). Upon further questioning, Bevan elaborated:

> Q. [Liaison counsel for plaintiffs] . . .
>
> [Do] you recall receiving documents in the form of [PX-101], [PX-102] and [PX-103] at or about that time?
>
> A. [Mr. Bevan] Well, as I say, I have no recollection, and _they_ _are_ _in_ _not_ _what_ _I_ _remember_ _as_ _the_ _regular_ _form_."

(_Id_. 172) (emphasis added).

In this instance, the admission of the documents in evidence as business records is particularly prejudicial because of the manner in which the substantive law meshes with evidentiary considerations. Because § 12(2) places on the defendant, once a "fact" is proven, the burden of showing "that he did not know, and in the exercise of reasonable care could not have known," of this fact, to permit every document

found in the files of a third party during the course of the liberal discovery contemplated by the Federal Rules of Civil Procedure without some more than superficial guarantee of trustworthiness would place on the defendant an impossible burden.

Whatever the rule of evidence for admitting a document, with its deficiencies to go to its weight, when the party offering the document has the burden of establishing the element in question, a different rule is called for when once the document is admitted the burden of refuting it is passed to the party opposing admission. In § 12(2) cases, a stricter rule of admissibility should thus be required due to the shifting burden of proof, especially since "hesitation must be experienced in admitting everything which is observed and recorded in the course of a regularly conducted activity." Advisory Committee's Notes, Exception 803(6), 51 F.R.D. 315 428 (1971). Accord, J. Weinstein & M. Berger, Evidence ¶ 803(6)[05], at 803-165,-166 (1976).

The need for such a careful approach is demonstrated by the instant case. University Hill called no witness at this trial to testify about these documents. The only testimony it offered was that of Penn Central's post-litigation custodian of documents -- a witness who could not properly even authenticate them. Moreover, there was no

attempt during pretrial discovery to have these documents explained or authenticated, even in the face of the testimony of the responsible officer at Penn Central that they were not "regular documents." (Bevan Dep. 171).

Goldman, Sachs, on the other hand, produced not only their own experienced credit and commercial paper personnel who spoke of the impossibility of obtaining such memoranda (Wilson, Tr. 896-99; 1024-27), but also proferred the testimony of Mr. Sullivan, a financial officer of Manufacturers Hanover, who agreed with them. (Sullivan, FSB Tr. 866-67, 904-10).

Although the evidentiary complications caused by § 12(2)'s shifting burden were brought to the attention of the trial court (Tr. 153, 203-05), it nonetheless admitted the documents on the second day of trial with this qualification.

> "I will admit them for the purpose of indicating whether they were in the files, subject, of course, to any qualifications as to their dependability, which is brought out by the defendants, and I want to say that the qualifications that Mr. Maney has mentioned so far I think are very substantial and considerable and, in my opinion, if they are correct, sharply reduce the weight of the exhibits but I will allow them to go in."

(Tr. 205-06). Despite the court's statement, the uncontradicted testimony of Goldman, Sachs' witnesses, and the complete failure of University Hill to present any evidence

regarding these documents, the District Court made them the <u>sine qua non</u> of its opinion. 422 F. Supp. at 904.

3. <u>In Addition, Circumstances of Preparation Indicate Lack of Trustworthiness</u>

Besides the fact that University Hill did not make out a prima facie case for the admissibility of the Underhill memoranda, there is considerable evidence showing their complete lack of trustworthiness, especially that they were being taken out of context. Fed. R. Evid. 803(6).

Among the evidence showing the lack of trustworthiness is the testimony of Mr. Bevan quoted above that these are not "regular document[s]." Bevan also testified that when the first quarter results were actually received by him (at about April 20), the size of the loss as compared to the budgeted plan "stunned" him. (Bevan Dep. 57). Bevan testified that he had known that results for January and February were not up to budget, but expected much of this deficit to be made up in March as the backlog of traffic, stalled by an extraordinarily severe winter, began to roll again. The testimony is a further indication that the chief financial officer's own views were based upon what he was told by the "operating people" and the "sales people" within Penn Central (Bevan Dep. 57-58), rather than on any one particular document.

Bevan thus received material from a variety of sources, on the basis of which he made a judgment at the time that first quarter results would not be far off budget. (Bevan Dep. 57-58). To take one component of the information at his disposal distorts the significance of these working estimates, if that is what they really are, which can only be assessed when it is known how they were prepared, what use was made of them, who, if anyone, considered them and what weight, if any, was given them by Penn Central personnel. Lacking such information, there is no basis for saying that the documents were significant or trustworthy.

C. Goldman, Sachs Violated No Duty By Not Consulting With Brown Brothers Harriman and First National City Bank.

The court below added two points to its major premise that Exhibits PX-101, -102 and -103 could and should have been discovered: (1) that Goldman, Sachs should have consulted Brown Brothers Harriman to determine why it had removed Penn Central from its "approved list" of commercial paper issuers and (2) that Goldman, Sachs should have learned why First National City Bank ("Citibank") declined to participate in a loan to Pennco.

These matters are considered here lest this court conclude that the points have enough independent weight to render harmless the evidentiary and other errors set forth above.

Because the issuer's access to credit is important to a commercial paper analysis, Goldman, Sachs talked directly with major bankers who customarily lent money to Penn Central. Not only did Goldman, Sachs respect their judgment, but these bankers were likely sources of money if additional cash were needed to pay off Penn Central's commercial paper. Their views, therefore, not merely corroborate, but are actually a test of access to credit.

From the fall of 1969 to March 1970, Goldman, Sachs checked with major banks about their views on Penn Central's creditworthiness and learned that they too deemed Penn Central creditworthy. (E.g., Exs. A-84, A-76, A-68; Wilson, Tr. 864). 422 F. Supp. at 892. Yet, the District Court held Goldman, Sachs liable in part for not checking after February 6, with two of these numerous financial institutions about their views on the creditworthiness of Penn Central.

The only evidence on Brown Brothers' opinion on creditworthiness is "that Brown Brothers Harriman itself had an unsecured line of credit available to Penn Central and had in fact lent $2 million to Penn Central on April 30, 1970." Franklin, Fed. Sec. L. Rep. (CCH) ¶ 95,902, at 91,356. (Vogel, Tr. 546-47; Ex. BY). Thus had Goldman, Sachs asked for Brown Brothers' view, the reasonable inference is not

that it would have been told Brown Brothers doubted Penn Central, but that it thought Penn Central creditworthy. Otherwise why would it have lent money to Penn Central after the worse news of the first quarter earnings was released? See Alton Box Bd. Co. v. Goldman, Sachs & Co., 418 F. Supp. 1149, 1155 (E.D. Mo. 1976).

The court itself gives no indication of what it thought Goldman, Sachs would have uncovered by talking to Brown Brothers, and the record contains no such evidence.

The District Court also faulted Goldman, Sachs for not checking with Citibank because it was convinced that if it had, it could have learned that Citibank "had declined to participate in the [$50 million bridge] loan because of reservations about the continued heavy use of the relatively profitable subsidiary to channel money to the ailing railroad." 422 F. Supp. at 904. The only support for this statement is found in Exhibit PX-106, a memorandum of February 9, 1970 by Loder, entitled "Borrowings from Bank."

Like PX-101, -102 and -103, this document was neither authenticated* nor established as a business record.

---

* Exhibit PX-106 was admitted in evidence (Tr. 222) over an authentication objection (Id. 208) subject to connection (id. 208-09) on the understanding that a portion of the testimony of Raymond Lepley designated by University Hill would authenticate the document. (Id. 209) A search of Lepley's deposition reveals nothing remotely connected with this document. (Lepley Dep. passim).

In this case, however, the court recognized this fact and admitted it for the limited purpose of permitting plaintiff to try to show Goldman, Sachs should have found the document itself:

> THE COURT: I don't think that the question of hearsay arises with regard to the theory pressed by the plaintiff here.
>
> All they are saying is this would have alerted somebody, even if it was misinformation. They could have looked into it further.
>
> So I don't think it is offered for the truth of the contents, but just for the fact, as I have said.
>
> MR. ATLAS: That is correct.
>
> THE COURT: Under those circumstances, <u>recognizing that it is not competent at this stage, anyway, for the proof of its contents, I will admit it.</u>" (Tr. 222) (emphasis added)

Thus Exhibit PX-106 was neither offered nor received for the truth of the matter asserted, as well it could not be. Fed. R. Evid. 805. Yet, the District Court in its opinion uses the document only for the impermissible purpose of showing by triple hearsay that Citibank had adopted a certain policy for certain reasons.

None of the other testimony and exhibits cited by the Court support the proposition that Citibank declined for credit-related reasons to participate in the February loan, and there is no basis for inferring that such was the case.

This is shown by the fact, unknown to Goldman, Sachs at the time, that on February 11, 1970, Manufacturers Hanover decided to lend Penn Central an additional $10 million on an unsecured basis, even though it knew of Citibank's "declining" to participate and even though as a member of a syndicate managed by Citibank it had a contractual right to any information about Penn Central known by Citibank. (Sullivan, FSB Tr. 901-02; Exs. ET, B-19).

In sum, that Goldman, Sachs did not talk to two financial institutions about Penn Central when it regularly spoke to many more and when there is no evidence that either would have expressed a negative view of Penn Central's creditworthiness is irrelevant as a matter of fact and as a matter of law.

CONCLUSION

For the reasons set forth above, the judgment of the District Court should be reversed, or in the alternative, the judgment should be vacated and the case remanded for a new trial.

April 4, 1977

Respectfully submitted,

SULLIVAN & CROMWELL
48 Wall Street
New York, New York 10005
(212) 952-8100

Attorneys for Appellant,
Goldman, Sachs & Co.

MICHAEL M. MANEY
PHILIP L. GRAHAM, JR.
CHARLES E. DORKEY III

Of Counsel

ADDENDUM OF STATUTES AND RULES

Sections 3(a)(3) and 3(a)(6) of the Securities Act of 1933, 15 U.S.C. §§ 77c(a)(3) and (6):

Except as hereinafter expresssly provided, the provisions of this subchapter shall not apply to any of the following classes of securities:

* * *

(3) Any note, draft, bill of exchange, or banker's acceptance which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited;

* * *

(6) Any security issued by a common or contract carrier, the issuance of which is subject to the provisions of section 20a of Title 49;

Section 12(2) of the Securities Act of 1933, 15 U.S.C. § 77l(2):

Any person who--

*   *   *

(2) offers or sells a security (whether or not exempted by the provisions of section 3, other than paragraph (2) of subsection (a) thereof), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,

shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

(a) In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue --

* * *

(5) every underwriter with respect to such security.

* * *

(b) Notwithstanding the provisions of subsection (a) of this section no person, other than the issuer, shall be liable as provided therein who shall sustain the burden of proof --

* * *

(3) that (A) as regards any part of the registration statement not purporting to be made on the authority of an expert, and not purporting to be a copy of or extract from a

report or valuation of an expert, and not purporting to be made on the authority of a public official document or statement, he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading; and (B) as regards any part of the registration statement purporting to be made upon his authority as an expert or purporting to be a copy of or extract from a report or valuation of himself as an expert, (i) he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or (ii) such part of the registration statement did not fairly represent his statement as an

expert or was not a fair copy of or extract from his report or valuation as an expert; and (C) as regards any part of the registration statement purporting to be made on the authority of an expert (other than himself) or purporting to be a copy of or extract from a report or valuation of an expert (other than himself), he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement of the expert or was not a fair copy of or extract from the report or valuation of the expert; and (D) as regards any part of the registration statement purporting to be a statement made by an official person or purporting to be a copy of or extract from a public official document, he had no reasonable ground to believe and did not believe, at the

time such part of the registration statement became effective, that the statements therein were untrue, or that there was an omission to state a material fact required to be stated therein not misleading, or that such part of the registration statement did not fairly represent the statement made by the official person or was not a fair copy of or extract from the public official document.

(c) In determining, for the purpose of paragraph (3) of subsection (b) of this section, what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property.

* * *

Section 10(b) of the Securities Act of 1934, 15 U.S.C. § 78j(b):

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange--

*   *   *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Section 10b-5, 17 C.F.R. § 240.10b-5:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(1) To employ any device, scheme, or artifice to defraud,

(2) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceipt upon any person,

in connection with the purchase or sale of any security.

Rule 801 of the Federal Rules of Evidence:

* * *

(c) Hearsay. "Hearsay" is a statement, other than one made by the declarant while testifying at the trial or hearing, offered in evidence to prove the truth of the matter asserted.

* * *

Rule 802 of the Federal Rules of Evidence:

Hearsay is not admissible except as provided by these rules or by other rules prescribed by the Supreme Court pursuant to statutory authority or by Act of Congress.

Rule 803 of the Federal Rules of Evidence:

The following are not excluded by the hearsay rule, even though the declarant is available as a witness:

* * *

(6) Records of regularly conducted activity. A memorandum, report, or data compilation, in any form, of acts, events, conditions, opinions, or diagnoses, made at or near the time by, or from information transmitted by, a person with knowledge, if kept in the course of a regularly conducted business activity, and if it was the regular practice of the business activity to make the memorandum, report, record, or data compilation, all as shown by the testimony of the custodian or other qualified witness, unless the source of information or the method or circumstances of preparation indicate lack of trustworthiness. The term "business" as used in this paragraph includes business, institution, association, profession, occupation, and calling of every kind, whether or not conducted for profit.

Rule 805 of the Federal Rules of Evidence:

Hearsay included within hearsay is not excluded under the hearsay rule if each part of the combined statements conforms with an exception to the hearsay rule provided in these rules.

Rule 901 of the Federal Rules of Evidence:

(a) General provision. The requirement of authentication or identification as a condition precedent to admissibility is satisfied by evidence sufficient to support a finding that the matter in question is what its proponent claims.

(b) Illustrations. By way of illustration only, and not by way of limitation, the following are examples of authentication or identification conforming with the requirements of this rule:

*　　*　　*

(2) Nonexpert opinion on handwriting. Nonexpert opinion as to the genuineness of handwriting, based upon familiarity not acquired for purposes of the litigation.

*　　*　　*

CERTIFICATE OF SERVICE

Service of a copy of the annexed brief was made upon the following counsel for the parties herein by placing same in the United States mail, postage prepaid, this 4th day of April, 1977.

Solin & Breindel
Attorneys for Plaintiff-Appellee
645 Fifth Avenue, Suite 400
New York, N.Y. 10022

George A. Scholze

George A. Scholze
48 Wall Street
New York, N.Y. 10005
(212) 952-8100